

**INTERNATIONAL SEMINAR SYSTEM
TOOLS FOR THE SUPPORT OF
HOUSING DEVELOPMENT**

**OCTOBER 14-16, 1997
BRATISLAVA, SLOVAKIA**

**THE PUBLIC/PRIVATE
PARTNERSHIP AND HOUSING
FINANCE AND DEVELOPMENT**

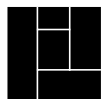
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Executive Summary

From October 14-16, 1997, the Ministry of Construction and Public Works organized an international conference called "System Tools for Housing Development Support." The Ministry requested that USAID support the participation of an U.S. expert in one of several areas of housing policy and development. Mr. Al Hirshen, who had provided limited assistance to the Ministry with a pilot public/private partnership in Skalica, Slovakia, prepared a paper called "The Public/Private Partnership and Housing Finance and Development" which was delivered at the conference. The paper discusses different models of public-private partnerships and the enabling steps the Slovak government must take for this approach to be successful in Slovakia.

Introduction

My experience in central and eastern Europe, the countries of the former Soviet Union and other countries around the world, including the United States of America, has led me to conclude that it is necessary to form public/private partnerships in order to provide significant affordable housing. Neither sector alone can or will meet the need. In most situations, the private sector commands substantially more financial resources than the public sector. However, it usually has less of a desire to commit them toward affordable housing.

The profit motive usually leads the private sector away from investing in affordable housing. Any attempt to bring the two sectors together in a partnership must be founded upon the realities that exist. In order for a partnership to work, any investment in affordable housing must be economically sound. The public/private partnership allows the government to move from a role of provider, in which it is involved directly in the supply of housing and the allocation of land, to a role as enabler and regulator in which it supports the leading role of the private sector in supplying and developing housing.

Strategy

A public/private partnership strategy with the government acting as enabler and regulator meets four important policy criteria: achieving equity, minimizing costs, maximizing efficiency and developing feasible policies and programs. While successful implementation of any strategy is, in the final analysis, dependent upon the macro-economic and political development in Slovakia, the strategy should be predicated upon the following factors:

- Leveraging - i.e., using government and donor funds to attract private financing.

- Targeting - i.e., adjusting the level and type of assistance to match the income of the group to be helped. Three main housing target groups should be considered:
 - Group 1 - high income. This small group is defined as those who can afford housing without government assistance. Government can support the expansion of the group by providing a reliable and efficient legal framework, e.g., quicker procedures for obtaining land plots, ability to use land as collateral, availability of credit, etc.
 - Group 2 - middle income. This group will require financial assistance in the form of affordable credit and some subsidies on land and/or infrastructure, as well as the development of public/private partnerships, modified plot size and infrastructure standards, etc.
 - Group 3 - low income/disadvantaged. This group will need substantial direct subsidies targeted at households, rather than at housing.
- Cost Recovery - i.e., government recovers infrastructure and other costs from the private sector as a way to renew its funds for housing.
- Institution Building - i.e., strengthening and expanding the role of private sector participants, such as developers and local government in the housing and land market.
- Coordination - i.e., coordination of physical, financial, socio-economic and institutional strategies for successful land and housing markets. In addition, coordination is essential between the different levels of government.

The above factors taken together stretch and target the limited government/donor financial resources available, while expanding the total pot of money with private resources. In addition, it expands the number of interest groups in the housing and land markets, creating much needed synergy.

It is clear that the private sector will not, on its own, finance affordable housing in any significant way. Thus, the public sector must provide incentives and mandates. Both sectors must commit to do what they do best with the public sector developing the policy framework and the private sector providing expertise and finance. It is best if both sides



have early input into the development of any strategy or program. For only through their shared experience will workable strategies and programs develop.

Legal Foundation

Public/private partnerships for financing and developing housing are predicated upon reliability and transparency. Reliability and transparency are the basic elements of such a relationship. Thus, needed legal reforms are essential for the efficient functioning of a public/private partnership strategy. Limited activity will take place without the legal reforms, but these transition activities will not develop into a viable market without such reforms. The private sector within and without Slovakia will not invest unless they are assured of their legal rights with respect to their investments. Simple notions of free transfer of private property, including land, dispute settlement mechanisms, clear and marketable title, use of land and unit to be purchased as collateral, access to collateral in case of default - all are necessary predicates to a successful public/private finance and development housing strategy.

Present laws which prevent charging market rates for rental apartments and recovery of government subsidies work in direct contradiction to development of a public/private partnership housing market.

Staged Transition Strategy

Existing activity in Slovakia and in other countries demonstrate that, with the right mix of public policy mandates and incentives, public/private housing finance and development partnerships can be an effective tool in the creation of housing.

Government incentives, education and mandates can be broadly described under the following categories: subsidies, guarantees, taxing power, regulatory power, educational programs (e.g., technical assistance and training) and NGO organizational substructures. The mix of incentives and mandates will change as political and economic circumstances change. However, no category is exclusive. A mixture of incentive, mandate and education is needed in order to be successful.

Given present legal, economic and political realities in Slovakia, it will take time to evolve to complete mortgage based public/private partnership system for housing. Thus, what is called for is a three-stage transition strategy.

■ **First stage.** The first stage would be founded on the existing legal and financial system in Slovakia, therefore, a legal system which does not clearly spell out rights and responsibilities with respect to sale or purchase of housing (including land and infrastructure). The existing banking system is limited by law to lending only sixty (60%) percent of the value of the housing to be purchased and requires one hundred and sixty (160%) percent collateral (this collateral must be in addition to the land and/or house to be purchased). Present law, although greatly improved, presents problems in case of default with respect to foreclosing on the collateral.

Even with all these and additional legal inadequacies, a public/private partnership strategy can be put in place to leverage government resources and attract private finance, as well as encouraging the development of private institutions (e.g., developers) which will further the process of building a viable private housing market.

In Skalica, such a government-enabled project has commenced. The project was initiated by the Ministry of Construction and Public Works (Ministry) together with the Mayor of Skalica and the Private Construction Contractors Association of Slovakia (PCCAS). Technical assistance was provided by the Urban Institute under a contract from the USAID. The project used the leverage of Ministry infrastructure and subsidy monies to entice involvement of private contractors and employer/investor financing, as well as local government land and infrastructure monies.

PCCAS acted in the role of developer and on April 18, 1997 signed a mandatory agreement with the municipality of Skalica. During the month of May with technical assistance from the Urban Institute, it negotiated with government officials to develop and collect the necessary documents for state financial support for infrastructure and construction. Under the Public Procurement Act, PCCAS organized a tender for the selection of a design studio. VPU-DECO, a forty-year old, multipurpose company was selected. On June 23, 1997, under the same tender principles, a construction contractor company UNI, s.r.o. was selected. PCCAS also organized the water, gas and electrical tenders.

The construction site was officially accepted July 7, 1997 and construction of a forty-two rental unit project was commenced. This is the first stage of the overall project and is scheduled for completion by December 1997. PCCAS oversees the adherence to quality and timetable on a regular basis. These rental units, under Ministry policy, will be available to government employees such as teachers, police, military, judiciary, etc.

The project leverages the infrastructure provided for these units to entice private finance and development. Two different employer/investor companies have had continuing negotiations with the municipality and PCCAS as developer/municipal representative to build a combination of single family and high-rise units for their employees. The employer/investors would provide two-thirds of the construction money and purchase the land at a below-market value. Additional financing would either come from foreign financial institutions or from PKB (First Communal Bank). If PKB were to provide individual unit financing, joint ventures between the employee and either the municipality or employer would be formed. This would allow municipality or employer collateral to be used as a basis for lending. As of this writing, negotiations with the employer/investors continue and are expected to be finalized within the next month. Employer/investor purchase of land would allow for partial recovery on the part of the municipality.

Other variations of public/private partnerships taking place in Slovakia during the present period involve municipal land with private developer or PCCAS involvement. In a number of these projects, private financing is being sought with the assistance of PCCAS. In Nové Zámky, building supply companies were investors. In Pezinok, three hundred and fifty new flats are being planned with PCCAS to select a suitable developer who can access private money sources for future owners. In



Prievidza, PCCAS is assisting the municipality with the tender and the development of a partnership to provide private financing. Similar activities utilizing municipal land as leverage to entice private contractor or developer involvement are being developed in Tmava, Prietrzka and Holíc.

It can be seen from the above examples that, at the very least, the beginning of the development of a private contractor/developer industry is being encouraged and slowly institutionalized. In addition, the Ministry is seeing the results of leveraging their subsidy monies to attract investor and possibly private banking financing. A first step has been taken. A similar first-step strategy is being developed in Moldova utilizing municipal land.

In addition, other models for public/private partnership can and have been utilized during this stage with mixed success. Municipalities can prepare competitions and/or auctions of land to attract private developers and finance. Such a strategy has been adopted, for example, in Hungary, Bulgaria, Russia, Moldova and in Slovakia with mixed results. The municipal land in question has been sold with and without infrastructure at market and below market prices depending on different circumstances and goals. The competition or auction must be carefully prepared by the municipality so that it meets the public policy purposes intended while, at the same time, being attractive to developers. Thus, below market sales might be required in order to attract private developers to produce affordable housing. In this case, the land acts as leverage to attract private finance and the policy of below market sales is targeted to certain income groups.

Situations can occur where such competitions do not attract needed developers either because the selected land is not well situated or there is not a sufficient developer community with access to private finance to take advantage of the competition. The advantage of the Skalica model is that it brought all the necessary parties of a public/private partnership together at the outset and they jointly created the project. This is not to say that well thought out competitions or auctions are not potentially useful tools for the development of housing. One issue that has arisen in the auction arena is whether the land will be sold as a leasehold or outright in what market economies would call fee simple. It is important to stress again that until a complete mortgage system is in place, the activities discussed above can only have limited success in developing a real estate market.

■ **Second stage.** The second stage would mean that basic legal changes have taken place and there is a necessary degree of reliability and transparency in the legal structure (especially with respect to using the property to be purchased as collateral, land sales, title registration and default remedies), but formal mortgage and foreclosure laws and, most importantly their implementation, are not in place. During this period, donor financing, among other activities, can be sought to develop longer term and lower interest rate lending. Long term donor financing may be accessed to develop an affordable interest rate lending program at PKB and other Slovakian banks. This program is based on addressing the banks' need for a source of long term, low interest monies, as well as clear and marketable title, and a straightforward and simple means of protecting itself in the case of default, especially with respect to new construction. Further, a program of underwriting technical assistance to these banks must be provided.

The Ministry, together with municipal government can, in tandem with the above program, offer subsidy/guarantee and tax incentives to further entice private and donor financing. The results of such a program will continue to be limited until a complete mortgage and non-judicial foreclosure system is in place. Because such a subsidy/guarantee, tax incentive program would be no different from one developed in Stage Three (albeit more limited in result), I will detail these and other public/private partnership programs below.

■ **Third stage.**

• **Subsidy/Guarantee**

Whatever the government subsidy or guarantee involved in supporting affordable housing, it is important that limited public funds be leveraged to attract private investment and be targeted to income groups in need to achieve maximum effects. This is neither a new or a necessarily complicated process. The public/private partnership allows government to maximize the impact of public funds by using them to subsidize or guarantee activities of private sector lenders and developers rather than using the funds directly for such purposes.

Depending on the program involved, such funds can assist lender profitability by not requiring them to deviate from market rates by too wide a margin not from sound underwriting by any margin. The use of partial or full guarantees can also minimize the lender's risk. Government funds can be used to allow financial institutions to attract new customers. A number of techniques utilized in the west have been through loan origination and servicing. Lenders can also function as agents for public programs providing administrative service, counseling and expertise.

— Public funds for affordable housing can be used:

- to “write down” or reduce market interest rates.
- to purchase from an institution affordable loans originated by them on a forward commitment basis where the government takes the risk of default.
- to collateralize a line of credit to a developer.
- to develop a down payment program either by direct grant or a silent second mortgage (this type of mortgage does not require monthly payments, but recovery of the loan amount is taken from equity upon sale of the property. Thus, underwriting must be carefully done to ensure sufficient equity to cover the soft second mortgage).
- as a cash reserve to protect lenders in the event of default.
- to “write down” or reduce the cost of land or infrastructure.
- to lessen the risk to private lenders during the pre-development stage.



The point is, public monies can leverage private financing and make loans affordable and/or reduce risk to private financial institutions and developers.

Guarantees can be utilized for many of the same purposes as cash subsidies including lowering interest rates and reducing risk. Indeed, the affordable housing private mortgage finance establishment of India started because of a guarantee loan from the United States government to the Indian government. I was honored to be part of the team that put this in place. Government must remember, however, that guarantees have the same effect from a budgetary point of view. Government budgets must make contingency provision in case the guarantee has to be utilized.

- **Taxing Power**

Taxing power can be used as an incentive to entice private persons or non-housing institutions to invest in affordable housing. This power can also be used to provide an incentive to financial institutions who support affordable house by increasing their profitability through a lowered their tax bite (e.g., profits derived from affordable housing are tax free or at least taxed at a lower rate). In the United States, current tax policy allows investors to reduce their tax liability on a dollar for dollar tax credit basis if they invest in affordable housing. This program has enticed long term profitable corporations to support affordable housing in a major way. In California alone, major corporations such as TransAmerica and major utilities have contributed equity funds which have resulted in over \$700 million of tax credit allocations, and over sixty thousand affordable housing units.

At other times in the tax history of the United States, tax exempt bonds issued by governmental agencies were utilized to provide below market rate mortgages for affordable housing. This program enables individual investors to maximize their return on investment while supporting the public policy of increasing affordable housing.

Whether a tax exempt bond or tax credit program is utilized depends on the interest rate market and the taxable bond rate market at any given time. Each strategy, however, utilizes the taxing power for a public purpose. It should be remembered that use of the tax powers in these ways does result in a loss of overall revenue to the government and, therefore, public policy considerations need to take this fact into account. Historically in America at least, the tax policy approach has been the major acceptable and politically realistic way to support housing even though it is not the most economically efficient approach.

- **Regulatory Power**

My experience in the Carter administration and over many years is that most financial institutions and developers will not provide for affordable housing on their own. In addition to the incentives of subsidy/guarantee and tax relief, government needs to provide a statutory and regulatory framework which directly ties government benefits to these institutions with their record of

affordable housing lending. This is what the Community Reinvestment Act (this act requires lenders to invest in all of the communities they serve, including affordable housing, in order to receive the benefits attendant to acquisitions, mergers and branching) in the United States is all about. Experience under this act demonstrates that over time financial institutions come to see the financial benefit and profitability of making affordable housing loans.

Any use of the regulatory powers of government must be predicated on a recognition that private financial institutions and developers are in business to make a profit. Legislation and regulation should not strangle the development of these much needed private institutions by being overly burdensome. A delicate balance of carrot and stick must be reached. In the end, the economics of the situation will prevail.



- **Educational Programs**

Subsidies/guarantees, taxing and regulatory powers alone will not provide for affordable housing. In conjunction with these necessary elements an educational program of training and technical assistance is required. A clearing house of information concerning affordable housing development needs to be created. Developers need to be connected with appropriate government officials and financial resources. Such networking not only provides information, but begins to favorably change the overall climate in which affordable housing takes place. Underwriting training is essential for financial institutions. Technical assistance to government at every level in the development of a workable policy framework is essential. While in the Carter administration, I have seen how videos and pamphlets, together with seminars and conferences such as this, created a greater understanding of the public/private partnership and moved affordable housing forward.

Education of potential homeowners of their rights and responsibilities through counseling programs have proved both essential and beneficial. Explaining the intricacies of home ownership, maintenance and financing to borrowers is an important tool in avoiding defaults, especially with first-time home buyers. Counseling builds a stronger and beneficial relationship between borrower and lender. Counseling programs are widespread throughout the United States. They vary in scope from informal loan counseling services, provided as part of the normal lending process, to fully lender-staffed neighborhood centers.

Non-Governmental Organization (NGO) Substructures

In order to successfully provide affordable housing, it is crucial that a network of NGO institutions devoted to affordable housing be developed. In Slovakia, this process has started with the creation of PCCAS. In the Ukraine and Russia, NGOs have been developed to represent the views of private citizens in the affordable housing process. Experience in the west, especially in the United States, demonstrates the critical role NGOs can play. In California, for example, NGOs act as developers of affordable housing. The quality of their developments and their financial track record is outstanding. Other NGOs, such as Local Initiative Support Corporation and the Neighborhood Reinvestment Corporation, have been essential in accessing corporate dollars for affordable housing, as well as providing training and technical assistance.

These NGOs have been at the forefront of supporting necessary legislative and regulatory changes. Together with enlightened private financial institutions and for-profit developers, they provide an all important political constituency for affordable housing.

Finally, the American Bar Association (ABA) provides legal assistance to, and has a clearinghouse function for, affordable housing. The contribution of lawyers and accountants to the public/private partnership strategy should not be overlooked. I have seen the benefits of this contribution firsthand as Chairman of the Subcommittee for International Affordable Housing Finance of the ABA.

Conclusion

In conclusion, in order to have a successful, affordable housing program, it is necessary to join together in a public/private partnership. This partnership allows government to leverage its limited funds to entice private enterprise to utilize its financial resources and expertise in the development of affordable housing. Only by a combination of incentive, education, NGO institution building and regulation can this goal be achieved. No one element standing alone can be successful. An integrated strategy of program and people is required to make widespread affordable housing a reality.

ANNEX A

CONFERENCE CONCLUSIONS